

Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

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CC:PSI:04

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Date: JUNE 21, 2006

Legend:

Grantor =

Spouse =

Child =

Grandchild =

Grantor's Trust =

Spouse's Trust =

Foundation =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Court =

State =

State Statute 1 =

State Statute 2 =

Dear _____ :

This letter is in response to a letter dated February 3, 2006 and prior correspondence from your authorized representative requesting rulings concerning the generation-skipping transfer (GST) tax consequences of the transaction described below.

The facts and representations submitted are summarized as follows:

On Date 1, Grantor created a revocable trust, Grantor's Trust, subsequently amended three times prior to Grantor's death with the last amendment dated Date 2.

Grantor and Spouse are deceased. Child and Grandchild are still living. Grantor's Trust provides that upon the death of Grantor, a trust is to be created for the benefit of Spouse. Spouse's Trust provides that net income is to be distributed at least quarterly to Spouse. Further, the trustees may distribute principal for the health, maintenance, support, and welfare of Spouse. Upon the death of Spouse, the trustees are to distribute the remaining principal and undistributed income of Spouse's Trust to such person or persons or to the estate of Spouse or in trust as Spouse appoints by will. To the extent any of the remaining principal and undistributed income is not appointed, the trustees are to hold the principal and undistributed income, in trust, for the benefit of Child and Grandchild. During the term of the trust, the trustees may, in their sole discretion, distribute principal or income for the health, maintenance, general welfare and support of either Child or Grandchild, or their issue, with full power to make disproportionate payments to beneficiaries of the trust. The trust is to terminate upon the death of Child. Upon termination, the remainder of the trust is to be distributed to Grandchild, if living, or otherwise to her then living issue by right of representation. Any of the remainder that is not distributed, as provided, will be distributed to Foundation.

Spouse's Trust was created after September 25, 1985. It is represented that the applicable fraction of Spouse's Trust for GST tax purposes is 79.3% and the inclusion ratio is 20.7%.

After Spouse's death, the remaining principal and undistributed income of Spouse's Trust has been held in further trust, Child's Trust, pursuant to the terms of Spouse's Trust and subject to a settlement agreement entered into on Date 3 and approved by Court on Date 4. The agreement was entered into by Child, individually and as personal representative of Spouse's estate; Grandchild; the personal representatives of Grantor's estate; the trustees of Grantor's Trust; and the trustees of Foundation, to resolve all claims and disputes related to the probate of Spouse's estate, Grantor's estate, Grantor's Trust, and Foundation. Pursuant to Spouse's Trust and the agreement, so long as Child and Grandchild are living, all of the net income of Child's Trust is to be paid to them, equally. The trustee of Child's Trust may, in its sole discretion, distribute principal for the health, maintenance, general welfare and support of either Child or Grandchild, or their issue, with full power to make disproportionate payments to beneficiaries of the trust. Upon the death of Child, the trust is to terminate and the remaining principal and undistributed income is to be distributed to Grandchild, if living, or otherwise to her then living issue by right of representation. Any of the principal and undistributed income that is not distributed, as provided, will be distributed to Foundation.

The trustee of Child's Trust, Child, and Grandchild propose to petition Court to sever Child's Trust into two separate trusts, Child's Trust 1 and Child's Trust 2. The assets of Child's Trust are to be allocated and transferred to the trustee of Child's Trust 1 and Child's Trust 2, so that Child's Trust 1 is funded with a fractional share of

the total value of all trust assets of the applicable fraction, as defined in § 26.2642-1(b) and (c), with respect to Child's Trust immediately before severance. Child's Trust 2 is to be funded with the balance of the trust assets of Child's Trust. The two separate trusts may be funded with the appropriate fraction, percentage or pro-rata portion of each asset held by Child's Trust, or on a non pro-rata basis; provided that if Child's Trust 1 and Child's Trust 2 are funded on a non pro-rata basis, each of the trusts must be funded by applying the appropriate fraction or percentage to the total fair market value of the assets of Child's Trust as of the date of funding. Child's Trust 1 will receive a fractional share of the total fair market value of the trust assets of Child's Trust equal to the applicable fraction and will have an inclusion ratio for GST tax purposes of zero (0). Child's Trust 2 will have an inclusion ratio for GST tax purposes of one (1).

Child's Trust 1 and Child's Trust 2 are to provide, in the aggregate, the same succession of interests of beneficiaries that is provided in Child's Trust. When the separate trusts are viewed collectively, the beneficiaries of Child's Trust 1 and Child's Trust 2 and the interests of the beneficiaries with respect to such separate trusts are to be identical to the beneficiaries and their respective beneficial interests with respect to Child's Trust before its severance.

Each trust will provide that as long as Child and Grandchild are living, all of the net income of Child's Trust 1 and Child's Trust 2, in the aggregate, is to be paid to Child and Grandchild, equally; provided that the trustee of Child's Trust 1 and Child's Trust 2, may in its discretion, pay different shares and amounts of net income of each particular separate trust to Child and to Grandchild, as the trustee determines, so long as each of them, in all events, is paid an equal amount of the total net income of the two separate trusts. In this regard, it is authorized that the trustee of Child's Trust 1 may pay a greater share of the net income from Child's Trust 1 to Grandchild than is paid to Child, and similarly, the trustee of Child's Trust 2 may pay a greater share of the net income of Child's Trust 2 to Child than is paid to Grandchild, to minimize the imposition of GST tax on distributions from the two separate trusts to Grandchild.

Each trust will further provide that during the term of Child's Trust 1 and Child's Trust 2, the trustee may, in its sole discretion, distribute principal for the health, maintenance, general welfare and support of either Child or Grandchild, or their issue, with full power to make disproportionate payments to beneficiaries of each or both of such separate trusts. No amount of principal paid is to be offset or recovered from the amount to which any beneficiary is thereafter entitled. Child's Trust 1 and Child's Trust 2 will each terminate upon the death of Child. Upon termination of Child's Trust 1 and Child's Trust 2, the remainder of the trust assets of each of the trusts is to be paid to Grandchild, if living, or otherwise to her then living issue by right of representation. Any of the remainder of Child's Trust 1 and Child's Trust 2 not effectively disposed of as provided above is to be distributed to Foundation.

State Statute 1 provides that the district court shall have original jurisdiction to construe the provisions of any trust instrument; to determine the law applicable thereto; the powers, duties and liability of trustee; and the existence or nonexistence of facts affecting the administration of the trust estate. State Statute 2 provides that a fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from elections and decisions that the fiduciary makes from time to time regarding tax matters.

Grandchild requests the following rulings:

1. The severance of Child's Trust into Child's Trust 1 and Child's Trust 2 will be a qualified severance under § 2642(a)(3).
2. If Child's Trust 1 receives a fractional share of Child's Trust immediately before the severance equal to the applicable fraction, as defined in § 26.2642-1(b) and (c), Child's Trust 1 will have an inclusion ratio of zero (0), and Child's Trust 2 will have an inclusion ratio of one (1).
3. Following the severance of Child's Trust into Child's Trust 1 and Child's Trust 2, distributions from Child's Trust 1 may be made on a non pro-rata basis to Child and Grandchild, such that distributions may be made selectively to Grandchild first and primarily from Child's Trust 1 which has an inclusion ratio of zero.
4. Distributions from Child's Trust 1 to Grandchild after the severance will not be subject to GST tax.

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer made by a transferor to a "skip person."

Section 2602 provides that the amount of the tax imposed by § 2601 is the taxable amount multiplied by the "applicable rate." Section 2641(a) defines applicable rate as the product of the maximum federal estate tax rate and the inclusion ratio with respect to the transfer.

Under § 2642(a)(1), the inclusion ratio with respect to any property transferred in a generation-skipping transfer is defined as the excess of 1 over the "applicable fraction." The applicable fraction, as defined in § 2642(a)(2), is a fraction, the numerator of which is the amount of the GST exemption under § 2631 allocated to the trust (or to property transferred in a direct skip), and the denominator of which is the value of the property transferred to the trust or involved in the direct skip.

Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 (adjusted for inflation

under § 2631(c)) which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2632(a)(1) provides that any allocation by an individual of his or her GST exemption under § 2631(a) may be made at any time on or before the date prescribed for filing the estate tax return for such individual's estate (determined with regard to extensions), regardless of whether such a return is required to be filed.

Section 2642(a)(3), which is effective in the case of severances occurring after December 31, 2000, provides that if a trust is severed in a qualified severance, the trusts resulting from such severance shall be treated as separate trusts thereafter for GST tax purposes.

Section 2642(a)(3)(B)(i) provides that for purposes of § 2642(a)(3)(A), the term "qualified severance" means the division of a single trust and the creation (by any means available under the governing instrument or under local law) of two or more trusts if the single trust was divided on a fractional basis, and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Section 2642(a)(3)(B)(ii) provides that if a trust has an inclusion ratio of greater than zero and less than 1, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of 1. Section 2642(a)(3)(B)(iii) provides that the term "qualified severance" includes any other severance permitted under regulations prescribed by the Secretary.

Section 2642(a)(3)(C) provides that a severance pursuant to § 2642(a)(3)(B) may be made at any time. The Secretary shall prescribe by forms or regulations the manner in which the qualified severance shall be reported to the Internal Revenue Service.

In the instant case, Child's Trust was irrevocable after September 25, 1985. Child's Trust will be severed into two trusts, Child's Trust 1 and Child's Trust 2. Child's Trust 1 and Child's Trust 2 will provide for the same succession of interests of beneficiaries as is provided prior to severance.

Accordingly, we rule as follows:

1. The severance of Child's Trust into Child's Trust 1 and Child's Trust 2 will be a qualified severance under § 2642(a)(3).

2. If Child's Trust 1 receives a fractional share of Child's Trust immediately before the severance equal to the applicable fraction, as defined in § 26.2642-1(b) and (c), Child's Trust 1 will have an inclusion ratio of zero (0), and Child's Trust 2 will have an inclusion ratio of one (1).

3. Following the severance of Child's Trust into Child's Trust 1 and Child's Trust 2, distributions from Child's Trust 1 may be made on a non pro-rata basis to Child and Grandchild, such that distributions may be made selectively to Grandchild first and primarily from Child's Trust 1 which has an inclusion ratio of zero.

4. Distributions from Child's Trust 1 to Grandchild after the severance will not be subject to GST tax.

The severance should be reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations," and a Notice of Qualified Severance should be attached to the return. The Notice must contain: a statement identifying the trust that is severed, the name of the transferor of the trust, the date of creation, the tax identification number, and the inclusion ratio with respect to the trust before severance; and a statement identifying each of the new trusts created as a result of the severance, the name and tax identification number of each new trust, the fraction of trust assets received by each new trust, other details explaining the basis for funding each new trust (a fraction of the total fair market value of the assets on the date of funding or a fraction of each asset), and the inclusion ratio of each new trust. The return and attached Notice must be filed by April 15th of the year immediately following the year during which the severance occurred or the last day of the period covered by an extension of time, if an extension of time is granted.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In addition, we express or imply no opinion regarding the value of the property transferred to the trust.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Pursuant to the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Each ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
(Passthroughs & Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter

cc: